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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

18 June 1984

Persian Gulf War: Oil Market Response

Summary

The escalating attacks on Persian Gulf shipping over the last two months have had little impact on exports from the region or market perceptions of oil availability. With a large surplus of tankers worldwide, shipowners remain willing to risk Gulf voyages as long as insurance is available. The region's oil producers for their part, have been willing to offset higher shipping costs to ensure near normal exports and most crude buyers have yet to turn to alternative sources outside the Gulf. As long as the oil market continues to believe that Western intervention will prevent a major disruption and government-owned stocks will be available to quickly dampen price increases, reactions to repeated tanker attacks will be muted. We believe a major escalation of hostilities such as daily strikes against oil tankers or Iranian attacks against the oil facilities of Iraq's Gulf supporters, however, could change market perceptions and produce an immediate, if only temporary, jump in spot oil prices. Should Iran succeed in severely damaging Gulf export capabilities or sustain a partial closure of the Strait of Hormuz, market reaction is likely to produce a substantial ($10-15 per barrel) but short-lived oil price rise. [redacted] 25X1

This memorandum was prepared by [redacted] Energy Markets Branch, [redacted] Petroleum Resources Branch, and [redacted] International Transportation Branch, Office of Global Issues. This information contained herein is updated to 18 June 1984. Comments may be directed to [redacted] Chief, Strategic Resources Division [redacted] 25X1 25X1 25X1 25X1 25X1

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Background

Iraq's attack on the Greek registered tanker Filikon L in late March marked the beginning of a series of attacks against oil tankers in the Persian Gulf. By mid-May the Iraqis had attacked an additional five tankers, causing significant damage to four of the five ships. As a result, chartering costs and insurance rates for vessels still willing to load oil at Iran's Kharg Island increased substantially. Faced with this threat to its oil exports, Iran countered in mid-May with attacks against two Kuwaiti and one Saudi tanker, reiterating its earlier warning that unless Iranian oil could safely transit the Gulf, no Persian Gulf shipping would be safe. Market reaction to the increasing frequency and severity of Iraqi and Iranian attacks against shipping, however, has been relatively calm to date because most market participants appear to believe that a significant, sustained oil supply disruption is unlikely. [redacted] 25X1

Impact on Shipping

The attacks so far have had little impact on the willingness of most tanker owners to operate in the Gulf. With a substantial surplus of tankers, we believe some owners will remain willing to take the risk of Gulf voyages as long as insurance is available. At least 50 million deadweight tons (168 ships)--about 20 percent of world tanker tonnage--are idle worldwide and charter rates have been severely depressed, forcing very large tankers to consistently operate at a loss. The higher charter rates available for risky voyages to the northern Gulf offer lucrative profits to shipowners willing to commit their ships to the journey. According to industry press reporting, an oversupply of crewmen from less developed countries virtually guarantees a sufficient number of seamen to man vessels making the trip. Most non-union seamen who have maritime jobs are fearful of losing them if they refuse to go. Moreover, crews willing to make risky Gulf voyages receive substantial bonuses--some reportedly double the normal wage for recent trips to Khark Island. [redacted] 25X1

According to industry press reporting, the attacks pushed up charter rates dramatically in May--as much as 300 percent for some liftings from Khark. Persian Gulf public chartering activity dropped from an average of 13 charters per week to only four in the week following a flurry of tankers attacks in mid-May. When public chartering returned to above normal levels in late May, typical rates for Khark voyages to Western Europe were up by almost 150 percent over early May. Rates for northern Arab ports had increased 60 percent and those for southern Arab ports were up 22 percent over the same time frame. These increases made trips more profitable for shipowners willing to accept the added risks. [redacted] 25X1

[redacted] 25X1

[redacted]

War risk insurance rates for tanker hulls and cargoes increased on four separate occasions in May, reflecting the concern of London underwriters over the shipping attacks. Hull insurance rates for Khark traffic increased more than four-fold to 7.5 percent of insured value during the month and comparable rates for northern Arab ports went from practically nothing to 3 percent. Cargo insurance rates over the same period increased ten-fold at Khark to 5 percent of insured value and from virtually nothing to 2 percent of value at northern Arab ports. Southern Gulf tanker insurance rates were only slightly affected by the month's attacks. We believe many shipowners are more than willing to pay these premiums because the insurance would more than cover their vessels' current market value. Despite press reports that underwriters may cancel insurance completely, we believe some type of insurance will be available to those willing to risk the trip. [redacted] 25X1

Offsetting New Costs

As long as most tanker owners are willing to make Gulf voyages, we believe the most important determinant of the level of Gulf exports will be the delivered price of oil. The high charter rates and cargo insurance costs facing crude buyers have to be offset by Gulf producer discounts in some form as long as buyers can find competitive alternatives elsewhere. Kuwait has responded by providing free cargo insurance, according to embassy reporting. Tehran has reportedly set up an insurance fund in London in addition to discounting the price of oil. Gulf Cooperation Council producers have also stated their willingness to adjust credit terms to offset the added costs of lifting their oil and have jointly agreed to replace any crude lost in tanker attacks. We believe that only if Gulf oil producers become unwilling to offset growing insurance and charter costs--possibly when the net price of Gulf oil is reduced to $20 per barrel--will Gulf oil exports decline significantly as buyers increase purchases from non-Gulf producers. [redacted] 25X1

Iranian Oil Exports

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We believe Iranian oil exports in May averaged about 1.5 million b/d, down only 300,000 b/d from April [redacted] Iran's oil exports 25X1 were at least 1.7 to 1.8 million b/d through the first half of the month, largely because charter and insurance rates remained unchanged, despite a late April Iraqi attack on a supertanker near Khark Island. [redacted] 25X1

A series of Iraqi and Iranian attacks on Gulf shipping in mid-May however, had a substantial impact on Iranian export activity. Hull and cargo insurance rates were boosted substantially, resulting in growing uncertainty over insurance costs that caused a number of shipping firms to withdraw their

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tankers from the Gulf or postpone loadings until June. As a result, Iranian exports fell to about 800,000 b/d during the 18-24 May period. [redacted] 25X1

Tehran moved quickly to reverse the decline in its oil trade [redacted] Iranian willingness to 25X1 negotiate concessionary terms and offer price discounts of more than $2 per barrel to offset higher shipping costs lured many shipowners back to Khark and helped raise oil export levels to nearly 2 million b/d through the first week of June. We believe the recovery in Iranian oil exports temporarily relieves some pressure on Tehran to retaliate against other producers in the Gulf. Nonetheless, Tehran may be forced to make additional price concessions to offset further increases in insurance rates should attacks against Khark-bound tankers persist as we now expect. [redacted] 25X1

Other Gulf Oil Exports

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Saudi crude oil loadings in May dropped about 200,000 b/d from April's level of 3.8 million b/d. We believe, however, that this marginal decrease in exports may have been caused as much by seasonal slack oil demand as it was by the increase in attacks on tankers. Higher insurance rates for destinations on the Arab side of the Gulf may have caused some shippers to reschedule loadings at ports outside the war zone, accounting in part for a small fall-off in tanker loadings at Ras Tanura and Juaymah. [redacted] 25X1 [redacted] oil flows through the pipeline to Yanbu more than doubled--to 1.3 million b/d--in the last week of May. Press reporting indicates that tanker 25X1 nominations to Yanbu in June and July have increased significantly, and by the end of June the pipeline's full capacity of 1.85 million b/d may be utilized for the first time since it opened in 1981. [redacted] 25X1

Embassy sources report that the impact of the attacks on Kuwait was minimal, dropping oil exports only about 100,000 b/d over the last half of the month. Kuwaiti officials are worried, however, and have taken, or are studying, steps to maintain crude oil sales. In addition to offering to provide free cargo insurance to foreign tankers, Kuwait has also arranged to shuttle crude to locations outside the war zone for transshipment oil to purchasers' tankers. Kuwait's refined product exports--which comprise almost half the country's oil sales--are carried primarily on Kuwaiti-owned ships and have not been affected by the recent increases in shipping fees. [redacted] 25X1

In other areas of the Gulf, oil production and exports remained relatively close to April's levels. Despite its proximity to the recent Iranian attacks on Arab tankers, output from the Neutral Zone--about 400,000 b/d--was not affected

[redacted]

significantly. In the southern Gulf, Abu Dhabi is reported to have actually increased oil production at its onshore fields by 100,000 b/d in the latter part of May, possibly in response to oil supply disruptions from northern producers. [redacted] 25X1

Oil Market Reaction

Market reaction to events in the Persian Gulf has been relatively calm to date. Spot crude oil prices initially rose $.50 to $1.00 per barrel following the Iranian attack on the Yanbu Pride on May 16 but, as with previous incidents, prices quickly subsided to near earlier levels. [redacted] 25X1
[redacted] most of the increase in spot prices following reported 25X1
attacks has been generated by speculative trading and these increases are not sustainable given underlying weak market conditions. Moreover, most [redacted] appear to share the 25X1
perception that:

- o a closure of the Strait of Hormuz is highly unlikely and could not be maintained in the face of the expected US/Allied intervention,
- o surplus productive capacity of about 3 million b/d outside the Persian Gulf will be readily available in the event of a major supply disruption, and
- o governments of the major consuming countries--especially the United States--will allow companies access to government-owned or controlled inventories to meet any remaining supply shortfall in order to moderate price increases.

[redacted] 25X1
most OPEC members have little desire to see another uncontrolled upward spiral in official oil prices for fear this would spur additional conservation and substitution away from oil in an already soft oil market. Therefore, [redacted] expect 25X1
these countries to increase oil production to help meet any supply shortfall. [redacted] 25X1

Despite the relatively calm reaction thus far, we believe that there has been some move by market participants to increase oil stocks. [redacted] stock 25X1
levels are now 100-150 million barrels higher than the company had forecast for the second quarter because of Gulf uncertainties. In addition, we believe that the potential for further escalation in the Gulf has helped to maintain spot oil prices at a higher level than would otherwise be the case.
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The reactions of West European governments have also been tempered by their belief that current oil stocks in combination with increased purchases of oil from producers such as Nigeria and Libya would meet their needs for up to 6 months. The

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Japanese--who rely on Persian Gulf oil to meet about 60 percent of requirements--have shown more concern about recent attacks, but apparently believe that judicious use of demand restraint coupled with existing Japanese oil inventories will allow Tokyo to meet its requirements without a major impact on oil prices.

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Outlook

In our view, market calm rests primarily on present industry perceptions that the combatants are not capable of significantly disrupting Gulf oil supplies. Should these industry perceptions of the Gulf situation change substantially in the coming weeks, a significant, albeit short-lived increase in oil prices is likely in response to an escalation of hostilities against oil targets. We believe the key indicators to signify such changes in market perceptions include:

- o Sustained spot price increases for Nigerian or North Sea crudes of $.50 per barrel or more.
- o Noticeable increases in production (200,000 b/d or more) from non-Gulf producers including Nigeria, Mexico, Libya, and Venezuela.
- o A noticeable increase in spot or government to government oil transactions for key importers such as Japan, France, or Italy.
- o Attempts at further stockbuilding that would include an increase in overall OPEC crude production to a level in excess of 19 million b/d as compared to estimated May production of 17.4 million b/d and
- o Saudi deliveries at the 1.85 million b/d capacity of Petroline with no decline in exports through Saudi Persian Gulf ports. 25X1

We believe a major escalation of hostilities such as daily strikes against oil tankers or Iranian attacks against the oil facilities of Iraq's Gulf supporters would produce an immediate, if only temporary, jump in spot oil prices. Should Iran succeed in severely damaging Gulf export capabilities or sustain a partial closure of the Strait of Hormuz, however, market reaction is likely to produce a substantial ($10-15 per barrel) but short-lived oil price rise. 25X1

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Persian Gulf: Estimated Oil Exports[a]

(million b/d)

	April	May
TOTAL	**8.7**	**8.1**
Iran	1.8	1.5
Iraq	0	0
Kuwait	0.9	0.8
Neutral Zone	0.4	0.4
Qatar	0.3	0.3
Saudi Arabia:	4.1	3.9
Persian Gulf	3.6	3.4
Red Sea/Yanbu	0.5	0.5
United Arab Emirates	1.2	1.2

a Including Natural Gas Liquids (NGLs).

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Persian Gulf: Selected Crude Oil Prices

US $ PER BARREL

LIGHT CRUDE (33° and above API)	Official Price	Spot Market Price (Week ending 1 June unless indicated)	Adjustment to Official Price	Estimated Transport Cost	Delivered Price (Western Europe)
Saudi Arabia					
Light 34°[1] (Ras Tanura)	$29.00	$28.40 (6 June)	-0-	1.06	29.46
Light 34° (Yenbu)	$29.25	$28.40	-0-	.63	29.03
Berri 39°	$29.52	$28.95	-0-	1.06	30.01
Hout 35°[2]	$28.60	$26.30	-0-	1.78	28.08
Iran					
Light 34°	$28.00	$24.50	-$2.30	3.06[4]	25.26
Abu Dhabi					
Murban 39°	$29.56	$29.25	-0-	1.06	30.31
Qatar					
Dukhan 40°	$29.49	$28.85	[illegible]	1.06	29.91
MEDIUM CRUDE (29°-32° API)					
Saudi Arabia					
Medium 31°	$27.40	$27.45	-0-	1.06	28.51
Iran					
Heavy 31°	$27.10	$23.60	-$2.30	3.06[4]	24.36
Kuwait					
Kuwait 31°	$27.30	$24.80	-0-	1.37[3]	26.17
Dubai					
Fateh 32°	$28.86	$28.15	-0-	1.06	29.21
HEAVY CRUDE (below 29° API)					
Saudi Arabia					
Heavy 27°	$26.00	$27.10 (6 June)	-0-	1.06	28.16
Khafji 28°[3]	$26.03	$24.00	-0-	1.06	25.06

1 OPEC benchmark.
2 Neutral Zone production shared equally with Kuwait.
3 Kuwait is providing free cargo insurance for crude shipments.
4 Iran has created a fund in London to provide insurance at reduced premiums.

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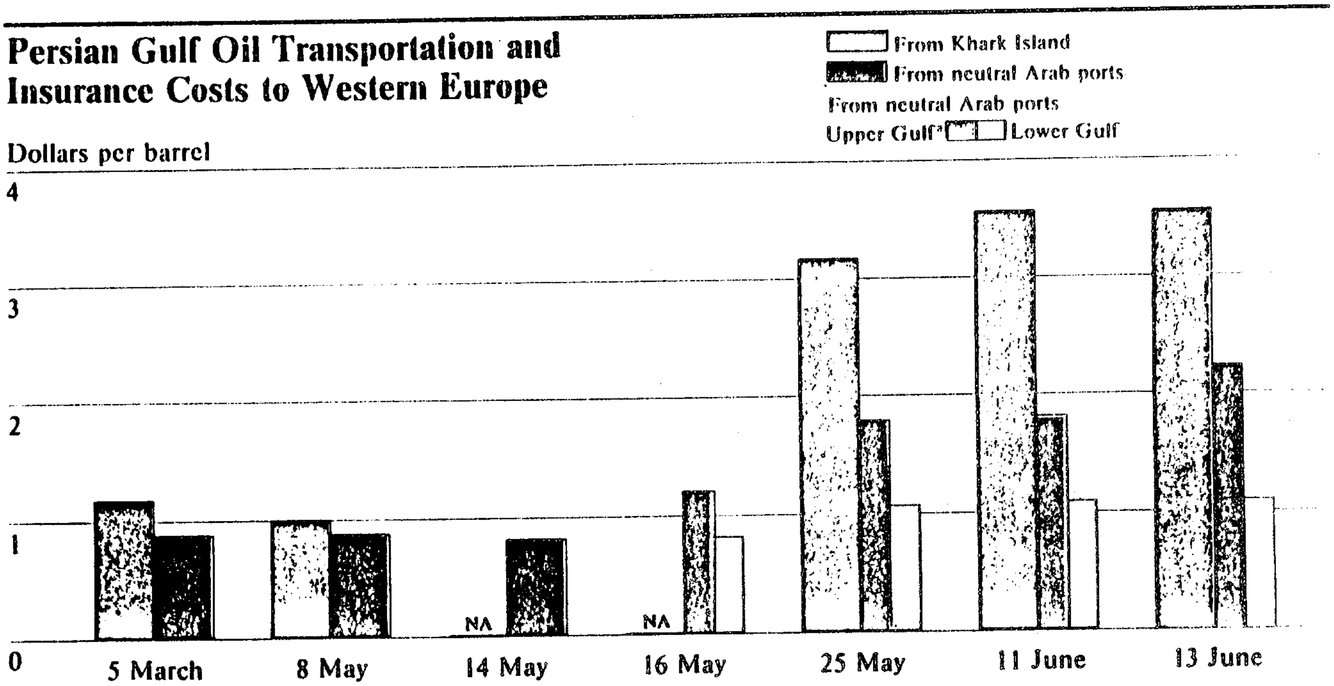
Persian Gulf Oil Transportation and Insurance Costs to Western Europe



[a] Covering liftings from ports above 27 degrees, 15 minutes North.

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SUBJECT: Persian Gulf War: Oil Market Response

OGI/SRD/EMB [redacted] (18 June 1984) 25X1

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